

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER: [REDACTED]:TL-N-2972-00
[REDACTED]

date: June 26, 2000

to: Chief, Examination Division, [REDACTED] District
and Excise Tax Agent [REDACTED]

from: [REDACTED]
Special Litigation Attorney

subject: [REDACTED]
Excise Tax Exemption for Political Subdivisions of States
Final Advisory Opinion

DISCLOSURE STATEMENT

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ISSUE

What is the probability that the government will be sustained in denying [REDACTED] the diesel fuel excise tax exemption granted to states and political subdivisions under I.R.C. § 4041(g)(2)?

CONCLUSION

The probability that the government will be sustained in denying [REDACTED] the exemption from diesel fuel excise tax under I.R.C. §§ 4082(a)(1) and 4041(g)(2), is [REDACTED].
(b)(5)(AC)

FACTS

[REDACTED] is the residential natural [REDACTED] company for the City of [REDACTED]. [REDACTED] operates under the authority of Title [REDACTED], Chapter [REDACTED] of the [REDACTED] Code. This chapter authorizes [REDACTED] in the State of [REDACTED] to form Departments of [REDACTED] to operate [REDACTED], [REDACTED], [REDACTED] and [REDACTED] within the jurisdictional limits of the city.¹ The authority of the [REDACTED] extends only to [REDACTED] that the Department [REDACTED] or [REDACTED]. [REDACTED] \$ [REDACTED]. To date, the [REDACTED] is the only [REDACTED] company in [REDACTED] that the [REDACTED] has [REDACTED] or [REDACTED].

By statute, the [REDACTED] is managed by a Board of Directors which, in turn, is appointed by a Board of Trustees. [REDACTED]. The Board of Trustees is essentially a self perpetuating body, in that nominations and approvals for the position of trustee are made by the board itself. [REDACTED]. Once nominated and approved by the board, the mayor of the city is required to approve the appointment so long as the nominee meets the minimum statutory age and residency requirements. [REDACTED]. Thereafter, a trustee may only be removed by judicial process for neglect, incompetence, disability or other good cause before the expiration of his term (four years). [REDACTED]. Thus the elected body of the City of [REDACTED] has little, if any effective control over the operation and management of [REDACTED].

The Board of Directors of the Department has the authority to condemn property for use in providing [REDACTED] service. [REDACTED]. The Board of Directors has the authority to issue bonds in the name of the city to borrow money for the acquisition of property. [REDACTED]. In addition, the Board may assess real property taxes against property in the city in the event the earnings of the [REDACTED] company are insufficient to pay [REDACTED].

¹ The City of [REDACTED] is currently the only [REDACTED] in the State of [REDACTED].

the bonds. [REDACTED]. If there are outstanding bonds payable via a property tax assessment in any given year, any excess earnings of the [REDACTED] are paid to the city treasurer. [REDACTED] The excess earnings are treated as tax receipts and may be used by the City of [REDACTED] for any lawful purpose.

In [REDACTED], the Attorney General for the State of [REDACTED] issued an opinion that vehicles owned and operated by [REDACTED] are exempt from state excise taxes and registration requirements. The ground for this opinion was that [REDACTED] was considered by the Attorney General to be a political subdivision of the City of [REDACTED]. Earnings from [REDACTED] are exempt from state and local income taxes. In addition, interest on bonds issued by the [REDACTED] are exempt from state and local taxation. [REDACTED].

DISCUSSION

I.R.C. § 4081 imposes an excise tax on diesel fuel and other motor fuels. States and political subdivisions of states are exempt from the excise tax as it applies to diesel fuel. I.R.C. §§ 4082(b)(1) and 4041(g)(2).

The term "political subdivision" is not defined under the Internal Revenue Code. However, a working definition of "political subdivision" has evolved through a number of court cases and revenue rulings. A political subdivision for purposes of the excise tax is a true governmental subdivision or any subdivision of the state created for a public purpose and authorized to exercise a portion of the sovereign power of the state to a limited degree. Rev. Rul. 83-131, 1983-2 C.B. 184. This definition has been used to approve the exemption in a number of revenue rulings. Thus, a state off-track betting corporation possessing powers of eminent domain, as well as police powers regarding gambling and which was governed by a publicly appointed board of directors was exempt. Rev. Rul. 78-138, 1978-1 C.B. 314. A public transit authority which exercised powers of eminent domain as well as rate making authority was exempt. Rev. Rul. 79-95, 1979-1 C.B. 331. Irrigation districts exercising eminent domain powers, as well as authority to make assessments on landowners within the district and subject to public control were granted exemptions. Common to these rulings is the notion that the entity subject to the exemption was controlled by the state and also was delegated a portion of the state's traditional sovereign powers such as the power of eminent domain, the power to tax, and police and regulatory powers. The rulings make clear that an entity need not possess all of the traditional sovereign powers to be considered a political subdivision so long as the powers possessed are substantial in effect. Rev. Rul. 78-138, 1978-1 C.B. 314, 315.

In the subject case, [REDACTED] has been delegated traditional sovereign powers. As stated above, [REDACTED] has the power to condemn property and also has the power to tax property located within its jurisdictional boundaries. In addition, [REDACTED] has the power to issue bonds in the name of the city, which also has been noted as a sovereign power in some cases. Moreover, these powers are substantial in that they may be exercised without the approval or review of the elected governmental body of the city. In addition, the providing of [REDACTED] has been noted as a traditional public service. Commissioner v. Shamberg's Estate, 144 F.2d 998, 1004 (2nd Cir. 1944).² Thus, absent any contrary circumstances, it appears that [REDACTED] is entitled to the exemption.

Contrary circumstances, however, do cast doubt over whether [REDACTED] is entitled to the exemption. As stated above, the traditional definition of political subdivision has two parts. First, a political subdivision exists where the entity is a true governmental subdivision. Second, the rulings and cases have taken on a broader definition indicating that any subdivision of the state that serves a public purpose and that has been delegated a portion of the traditional sovereign powers is a political subdivision. Rev. Rul. 77-143, 1977-1 C.B. 340. Even though the second part of the definition is broad, there is a common theme between the two parts. The common theme is that the entity must be considered a subdivision of the state.

[REDACTED]

² Although the Shamberg case and other cases cited below deal with the definition of political subdivision under I.R.C. § 103, the inquiry is the same as under section 4041(g)(2).

The central question now posed is whether in order to be considered a political subdivision for purposes of the excise tax exemption, the entity must be subject to the control and authority of a governmental body. Clearly, [REDACTED] is not under the control or supervision of the City of [REDACTED] or any other governmental body. However, its genesis is in state law, it serves a public purpose and it does have at least two of the three traditional sovereign powers. Is that sufficient to qualify [REDACTED] as a political subdivision for purposes of the excise tax?

Although the case law is not entirely consistent, there is authority that the critical test for political subdivision status for purposes of federal tax law is whether an entity has been delegated sovereign powers. Texas Learning Technology Group v. Commissioner, 958 F.2d 122, 125 (5th Cir. 1992); Philadelphia National Bank v. United States, 666 F.2d 834, 839 (3rd Cir. 1981). Furthermore, the most critical and influential power is the power to tax. Texas Learning Technology Group, 958 F.2d at 125. [REDACTED] possesses two of the three traditional sovereign powers and one of powers possessed, the power to tax, is the most influential of the three.

Moreover, the test for the state subdivision nexus in at least one reported case was whether the entity was created by state law, not whether its actions were subject to governmental control. In the case of Seagrave Corporation v. Commissioner, 38 T.C. 247 (1962) the court's test for determining whether a number of volunteer fire departments were political subdivisions was whether the fire departments were created by statute and whether they had been delegated sovereign powers. Finding that neither question could be answered in favor of the volunteer fire departments, the court held that they were not political subdivisions. Finally, in the case of Washington State Dairy Products Commission v. United States, 685 F.2d 299 (9th Cir. 1982), a dairy commission created by state law was found unqualified as a political subdivision not because it was not a subdivision of the state, but because it had not been delegated any sovereign powers.

Based on the above, it is concluded that (b)(5)(AC)

[REDACTED]
[REDACTED]. The fact that the day to day functions of an entity are not managed or controlled by a governmental body has been relevant in some cases, but is not the crucial test. Since [REDACTED] was created by state law and has been delegated traditional sovereign powers, the (b)(5)(AC)

(b)(5)(AC)

This memorandum has been reviewed by the Office of the Assistant Chief Counsel (Field Service) under its Significant Advice Review Program. The Office Of Assistant Chief Counsel (Field Service) concurs with the opinion herein.

Meanwhile, If you have any questions or wish to discuss this matter, please contact me at [REDACTED].

(signed) [REDACTED]

[REDACTED]
Special Litigation Attorney

CC: [REDACTED], Acting District Counsel
CC: Roy Allison, Assistant Regional Counsel (TL)
CC: Assistant Chief Counsel (Field Service) Att: Ned Madden